Strategy Thoughts

June 2014

Will an economic outlook help this time?

Introduction

There is a growing complacency that all is well in the US economy thanks to the release of some slightly improved economic indicators. This growing complacency should be of great concern to investors as history has repeatedly shown that complacent comfort on the part of the 'crowd', particularly based upon economic reports and extrapolations, has always been sadly misplaced when it comes to investment markets.

In this month's Strategy Thoughts I explore several of those historic periods of 'complacent comfort on the part of the crowd' and review the 'value' that an economic outlook may have provided through those times. I also review the behaviour of the widely followed precious metals, the ten year government bond yield and the Japanese equity market recently. I am naturally very aware that I began last month's Strategy Thoughts by quoting the Zurich Axiom concerning the danger of confusing correlation with causality and therefore I hope I exercise extreme care in not falling into this very trap with the charts that I include in this discussion. Finally, I have been invited next month to speak at a conference where my opening remarks are limited to just seven minutes. In that time I am expected to describe what it is that I believe drives markets and how one should invest based upon that view. With that brief I thought a useful exercise would be for me to attempt to distil my thoughts on this very broad subject in writing ahead of the conference.

Will an economic outlook help this time?

Two recent headlines in Barron's illustrate the increasingly widely held view that the US economy is in good shape and improving;

Bob Doll Hasn't Given Up on Economic Growth

The Nuveen strategist expects the surprise decline in bond yields to "reverse as growth increases."

Blackstone's Byron Wien is Bullish on U.S. Economy

He's heard the pessimism. But the Wall St. veteran expects stronger economic growth and earnings.

And a Wall Street Journal headline touches simultaneously upon the growing economic and geopolitical 'comfort', or diminishing fear, displayed in markets currently and the reaction in the precious metals markets that I discuss later;

Gold Declines as Worries Ease Over Ukraine, U.S. Economy

Intraday Price Touches Four-Month Low

It is understandable that commentators, and so investors, look at all the seemingly continuous flow of measures and indicators that come out about the economy and build their outlook, for both markets and the economy, on the back of it all. As human beings we hate uncertainty and amidst any uncertainty we look for something to hold on to that may help to provide a glimmer of certainty. Behavioural psychologists refer to this behavior as anchoring. It is an understandable bias that is hard wired into us but many experiments over the last few decades have all demonstrated that we anchor on to all kinds of things that actually should provide no 'comfort amidst uncertainty' what so ever.

Sadly economic appraisals and forecasts fall firmly into this category when it comes to investment markets.

This highlights another of our biases or failings as human beings, and that is that we tend to forget the lessons we have learned in the past just at the point those lessons would prove most useful. As George Bernard Shaw famously wrote;

"We learn from history that we learn nothing from history."

It continues to amaze me firstly that so much of the financial media continues to be dominated by 'experts' telling us what markets are going to do based upon their outlook for the economy and secondly that investors 'buy in' to this approach. This, despite the fact that the majority of 'experts' and investors have been around long enough to have been given the opportunity of learning from the past several times.

Back in the late nineties and into the year 2000 the economic outlook was set fair and the majority took great comfort from the fact that 'this time was different' due to the economic miracle that had been provided by the technological revolution that was taking place. This massive wave of euphoria drove prices for technology stocks and expectations of their prospects to levels that can now, with the benefit of hindsight, be seen as preposterous. Few were calling for any kind of economic slowdown so when the recession hit America it was a massive disappointment and forecasts were slashed on all fronts. Unfortunately the tech heavy NASDAQ had already imploded. It fell by close to 80% and still languishes about 20% below those historic highs of fourteen years ago, this despite all, and probably more, of that promised by the tech revolution having actually come to pass.

At the depths of that miserable decline in the NASDAQ, and in the wake of what by then virtually everyone saw as having been a massive speculative bubble, the economic outlook was far from rosy. In fact the IMF employed the term 'stagnation' in their World Economic Outlook at the time. Anyone who through that miserable decline had learned the lesson of three years earlier, that economic forecasts were not particularly useful in building an investment view, would have been well placed to identify an important cyclical investment opportunity. From that depressed low markets rallied in a magnificent and broad fashion for the next almost five years. Eventually forecasts caught up with what had actually happened and then, as always seems to happen, they began to extrapolate that current trend even further and further into the future. As a result, by 2007 economic forecasts were almost universally optimistic and the IMF published their highest forecast for economic growth ever. Added to this expectations as to where the then prevailing belief in an 'ocean of liquidity', that was driving markets and M & A activity globally, would take markets knew virtually no bounds. Again, sadly the lessons of the recent past had been forgotten by most and the largest global collapse in asset markets for seven decades began.

As the March 2009 stock market bottom approached economic forecasts grew gloomier and gloomier, understandably the majority of investor expectations mirrored this gloomy outlook. And so when markets began to rocket higher the move was generally dismissed as just another 'dead cat bounce' and economic forecasts became even bleaker. Only once the move was well and truly established did economic forecast begin to brighten.

Over the last fifteen years hoping that an economic forecast would give investors an anticipatory heads up as to when a market may top and roll over, or bottom and begin to rally, has been a frustrating exercise, yet still, the majority of investors continue to cling to the idea that somehow economic forecasts are a sound basis for investment decision making.

Perhaps even more surprising to most investors would be to learn that even if by some remarkable miracle they were privy to a perfect economic forecast they may not be any better off. Unless, that is, they looked at markets in quite a different way. An example would be the experience of international investors in the Australian stock market through the GFC.

Had a global investor been told in mid-2007 that a global Financial Crisis lay in the immediate future and that virtually all major nations would suffer both economic and stock market collapses then he would definitely be in a better position than those not privy to this perfect economic foresight. If he was also told that only one major nation would manage to avoid a recession then it would seem logical that he would disproportionately weight his portfolio, ahead of the impending collapse, towards that nation's market. Had anyone been in such a position they would have known that Australia would be the only major nation that would avoid a recession. If they had taken all of their investments out of the US and placed them in Australia they would have dodged a 55% fall in the US market. However, despite the relative strength of the Australian economy there was no respite from the GFC in Australia. The Australian market fell by a similar amount to the US market but the Australian dollar also collapsed, the investor would have been better off leaving everything in the US market and substantially better off had he sold everything in the US market and left all in US dollar cash.

A number of lessons should be learned (and written down and remembered) as a result of the tumultuous decade and a half that so many of us have lived and invested through.

- Comfort should not be taken from a benign economic outlook, particularly if that outlook is widely embraced.
- Don't expect to be presented with an economic outlook that will anticipate a major cyclical reversal in investment markets.
- Even a perfect economic outlook ahead of the GFC would not have helped investors.
- Australia was amongst the worst performing markets despite being the best economy.
- All markets can fall. At times cash and preservation of capital needs to become an investor's prime focus.

In many ways this discussion gets to the heart of the question that I have been asked to cover next month in just seven minutes.

What drives markets and how should one invest?

Valuation does matter, and value investing does work. It is just that it works over time periods that do not sit comfortably with most investors. All asset classes display long term swings in valuation, from historically very very cheap, to historically very very expensive, and these huge swings in valuation tend to take ten to thirty years. Buying anything that is historically very cheap has always been a successful strategy, especially if that asset is held until it becomes very expensive and then sold, but this is something that most investors find very difficult to do.

We all, with the benefit of hindsight, can see that we want to have bought things, and lots of them, when they were very cheap but the question that needs to be asked is why were they very cheap? The answer is simple, anything that is historically very cheap becomes that way because no one wanted to own them. Interest in an asset that is languishing at historically very cheap prices will have dried up due to that assets prior poor performance and the real attraction of whatever has been hot. That no one is interested in that asset, and why no one should have any interest in it, will have become part of conventional wisdom. A few examples would be Asian stock markets at the depth of the Asian crisis

in 1998, gold in 2000 and US stocks in 1982. In each of these cases why no one would want to buy these assets was common knowledge and expectations on the part of investors were historically low, as were valuations. The opportunities are always obvious with hindsight but seizing them at the time requires immense intestinal fortitude and the confidence to be different.

Doing the same thing as everyone else may be comfortable but has never delivered anything but mediocre results.

At the other extreme we can all see that it makes sense not to own a lot of whatever is historically very expensive, but the question that we should ask is why is an asset historically very expensive. They become expensive because investors are clamouring to own more and more of whatever it is, irrespective of price. The media is full of rationalisations as to why price doesn't matter and at the same time analysts and economists compete with each other to come up with higher and higher forecasts.

These long moves, from historically very cheap to historically very expensive and back again, produce the secular bull and bear markets that historians talk about. Long term strategic asset allocations should be set to reflect secular positioning and to ensure that a portfolio owns more of what's cheap and less of what's expensive. Unfortunately, in most cases the reverse is true, partly due to market capitalisation determining allocations and also as a result of the herding instinct that is so strong in all of us that we daren't be too different.

So valuation work is essential in determining the secular positioning of markets and so long term asset allocations. Unfortunately, despite the frequency with which valuation based rationalisations are used it tells an investor nothing about what is going to happen over the kinds of time periods that most investors are interested in. Given we humans hate uncertainty we look for something to hold on to and valuation rationalisations, like economic forecasts, provide that comfort, albeit misplaced.

The journey from a secular peak to a secular trough is made up of several cyclical bear and bull markets. These are swings that can last several years and reflect the ebb and flow of expectations on the part of investors. The most recent example of this has been the series of bear, then bull, then bear and then bull markets that have been endured in the US and Europe over the last fourteen years. Each move has been driven by remarkable swings in investor enthusiasm or fear but the valuation extremes have been different through each swing, it is also the case that general economic expectations have severely lagged the swings in the markets with the most optimistic forecasts existing at, through and for some time after the peaks and the reverse at the troughs.

Understanding that it is swings in expectations that are reflected in markets allows one to look at the business and economic news in a different manner, it is not the news that drives markets; at least it is not the absolute level or magnitude of news that drives markets. It is how that news compares to expectations.

Through a cyclical bull market the news tends to continually improve, the more this happens the more we humans tend to inflate our expectations, we start to look for positive surprises. The problem is the more we start to expect a surprise the greater the risk of disappointment. Cyclical bull markets peak, not on bad news, but on news that is just not as good as by then the majority are hoping for. The reverse is true at cyclical troughs. The challenge here is that measuring expectations, or levels of mood is not a science, it is an art.

Long term strategic asset allocations can be set employing valuation metrics that are measurable. A tactical asset allocation, to capture the opportunity and avoid the risk presented by cyclical moves, is in many ways more challenging but can be highly rewarding. However, both SAA, based upon secular metrics, and TAA, driven by the art of establishing expectation based metrics, require the confidence to be different and a highly disciplined approach that eschews the siren song of comfort offered up by an economic forecast or a relatively short term valuation measure.

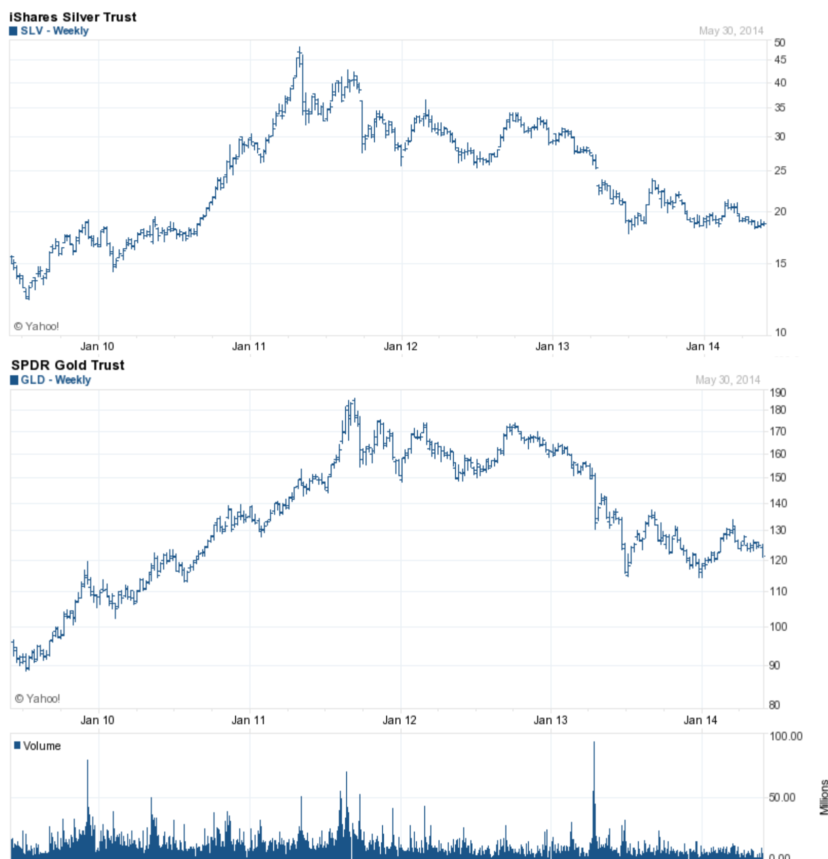
Gold and Silver

On the 2nd May 2011, in a Thoughts and Observations article titled "Bubbles, the Power of SIX and Silver", I discussed at some length the phenomenal run up that had been seen in the price of silver. The price of an ounce of silver had risen an incredible six fold over the prior two and a half years. I wrote;

> None of this, the six times appreciation or the explosion in retail volume, means that silver is about to collapse. Neither does the fact that justifications for silver's continued rise include conspiracy theories, about major banks being aggressively short and so vulnerable to a 'short squeeze', and arguments about there actually being a shortage of silver. However, when all of these ingredients appear together it is hard to believe that the mood and expectations of silver market participants are not being stretched, and stretched a lot.

I concluded with;

> Investing after anything has already delivered a six fold increase in an accelerating fashion is unlikely to be prudent.



With the benefit of hindsight it is clear that anyone who had jumped on the runaway train that silver was in late April 2011, and there were plenty of them, got in right at the peak. Within two weeks the price had fallen more than 35% and two years later the price had fallen more than 60% from its peak.

Gold did not peak with silver in April / May 2011, but I did note at the time that gold had also enjoyed a six fold increase, although that rise had taken more than ten years. Despite silver's collapse gold managed to rally for a further four months, and to eke out a further 20% rise, however, it then joined silver in falling.

By the end of 2011 gold was below where it had been at silver's peak in May and now sits 20% below that level and more than 30% down from its all-time high.

Over the last couple of years I have frequently commented on the continued enthusiasm displayed by commentators on gold. This has been evident in books such as '$10,000 Gold' that I highlighted as a warning sign when it was published last year, and continues to be seen with headlines such as this from Investing.com last week;

Gold Still In A Long-Term Secular Bull Market

It is unlikely that a final low, and so a great long term buying opportunity, will be seen in either gold or silver until such enthusiasm (and hope) is totally wiped out. It is worth remembering that at the last long term opportunity in gold, nearly fifteen years ago, central banks were dumping their reserves and no one had any interest in what had been a miserable performing asset over the prior two decades, particularly given the sensational bull market that stocks had delivered through much of that time.

It therefore seems that the precious metals are still sliding down their 'slopes of hope' from their all-time highs and it will be particularly interesting to see what happens to gold if silver breaks down below the low it recorded in the middle of last year. At the time of writing the silver ETF has closed within 25 cents of that low point.

The real question for investors is what continued weakness in gold and silver could imply for other assets. One observation would be that the weakness in the precious metals highlights a lack of fear on the part of investors, or increasing complacency. This is also supported by the marked weakness in the so called 'Fear Index', the VIX or volatility index. As the chart (left) shows, this index has already broken below the low levels seen mid last year.

The other trend that may be being highlighted by precious metal weakness is the threat, and fear, of deflation. Last month I touched on the growing fear of deflation within the Eurozone, over the last month that fear has only continued to grow as the following headlines illustrate;

Bond Yields Lowest Since Napoleon Are No Comfort to Europe Amid Deflation Fight (Bloomberg June 4)

Eurozone deflation fears add to pressure on Draghi (the FT June 3)

Deflation fears grow (Irish Independent 31 May)

And it is not just in the Eurozone that such fears are rising, on the 9th May the Daily Telegraph ran the following story;

China deflation fears as price rises slow sharply Economists warn "risk of deflation is looming" as consumer price rises slow to 18-month low

Complacency is never a healthy sign in a market and should cause investors to at least consider how things could go wrong. Complacency followed by deflation would be damaging for many of those asset markets that have continued to rise over the last couple of years. Many times over the last few years I have recommended that readers carefully consider the message that economist Gary Shilling put down at length in his book 'The Age of Deleveraging' and his earlier book 'Deflation'. A brief taste of the danger of deflation was experienced a couple of times during the last two cyclical bear markets, my major concern continues to be that what has been seen so far is a long way from all that 'The Age of Deleveraging' has in store for investors. Gary Shilling writes regularly for Bloomberg and I would recommend readers look at his four part series of articles on China;

http://www.bloombergview.com/articles/2014-05-26/dear-investors-china-s-problems-are-your-problems

Not only do they reinforce his deflationary outlook, they also provide an answer to that question, how things could go wrong and how a portfolio should be positioned!

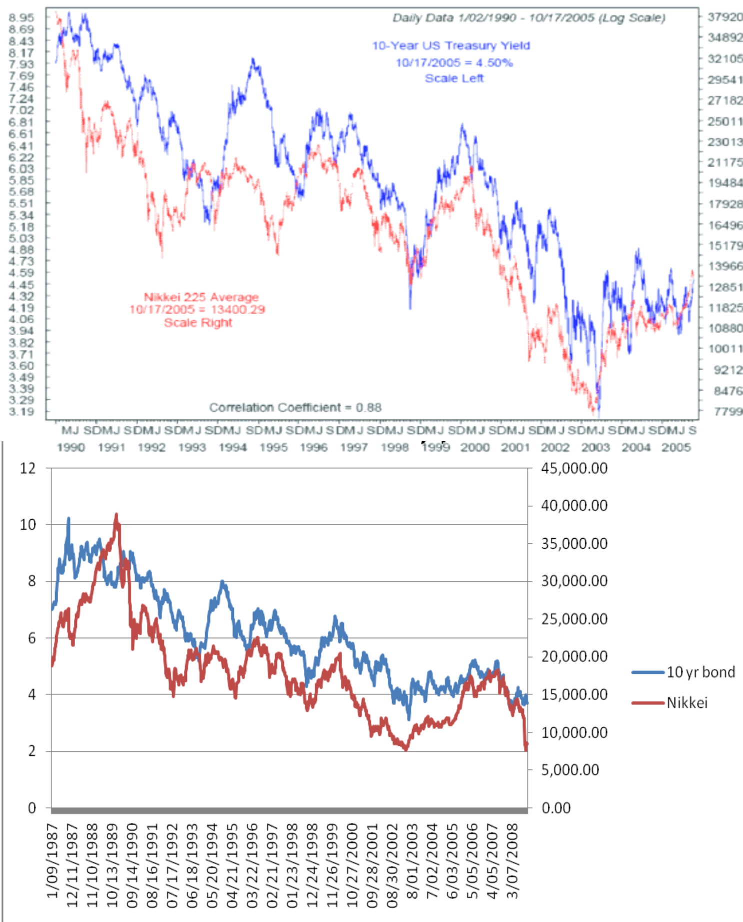
Bonds and the Nikkei

In the articles mentioned above three of Shilling's recommendations for investors are US treasury bonds, avoiding commodities and commodity linked currencies and avoiding major country equities. These all sit very comfortably with me and the threat, or risk, of deflation answers the question that I have been asked many times recently, regarding why there has been such strength in bond markets.

From a very long term perspective I continue to believe that the low yields seen on long dated US treasury bonds two years ago likely marked the end of the secular bull market in bonds that began more than thirty years earlier. However, a new secular bear market in bonds should not be expected to simply produce a steady rise in yields, there will be cyclical bear and bull markets along the way and the recent strength, confounding as it may be to many, should be put in perspective. From the low yield in mid 2012 the yield on ten year US treasuries more than doubled, from 1.4% to a fraction over 3%. Since that cyclical peak in yields at the end of last year yields have fallen to a recent low of 2.6%, they could still fall an awful long way and the new bear market in bonds, or bull market in yields, would still be intact.

The action of the bond market and Shilling's concern toward major market equities reminded me of a relationship that I have written about a number of times in the past, the at times almost spooky correlation between US ten year treasury yields and the movement of the Japanese Nikkei index.

Six years ago in Strategy Thoughts I included the chart (below) that had been produced by Marc Faber a few years earlier.



It illustrated the long term correlation, which he calculated to be a remarkable 0.88, between these two quite different assets. I then produced an updated version of the same relationship (left) and it appeared that the close relationship had remained intact and may even have got closer.

Given Shilling’s comments I checked to see whether the relationship was still intact and was struck by the correlation that has been present in these two assets over at least the last six months.

In this month’s introduction I stressed my awareness of not confusing correlation with causation, and I am certainly not saying that the Nikkei is driving the ten year yield or vice versa. However, I can quite easily accept that both are a reflection of the same emotion, or fear of deflation, that has produced the marked weakness recently in the precious metals markets. I can also imagine that if equity markets were to roll over decisively, whether or not it is due to the list of potential causes that Shilling refers to in his articles, then along with those falling equities we would see both precious metals and bond yields continue to fall.

In such an environment preservation of capital should be the most important goal for all investors.

Conclusions

Nothing that has happened over the last month has caused me to change my view and I am certainly not succumbing to the ‘siren song of comfort offered up by an economic forecast or a relatively short term valuation measure’ that I mentioned earlier. I continue to view the risk of the permanent loss of capital as the most pressing risk facing investors currently and so I continue to favour a strategy that focusses strongly on preserving capital.

I have long respected the analysis and writing of Dr John Hussman, and this has not been because our views have always been aligned as in fact they have not. His combination of economic thought and appreciation of the importance of emotion or sentiment in markets has been valuable over the last

twelve years or more. Currently my concerns do align with his; I therefore thought it worthwhile reproducing his closing comments his weekly letter from May 19th;

> In a financial market where price signals encourage savings to be allocated toward productive uses, what helps an individual investor often helps the entire economy. But in a severely distorted and speculative market, any effort to help one investor is really quite a zero-sum game that requires someone else to be injured. This is just an unhappy result that years of quantitative easing have now foisted upon us.
>
> Accordingly, I am changing my guidance. For those investors who trust our analysis and discipline, no change of course is encouraged. But for those who find our work to be a constant source of irritation to be regarded with open disdain, I am retracting all of it herewith – for you alone mind you – and I leave you free to buy with both hands to whatever extent you are inclined. Not that I *encourage* it really – that would be bad Karma – but someone is going to have to hold equities at these prices. It would best be those who are fully aware of our concerns and prefer to reject them. So the more you dislike my work, and particularly if you are nasty about it, I have no objection to you accumulating – perhaps on margin – as much stock from other investors as possible.

His frustration, both with the markets and his numerous critics, is obvious.

Kevin Armstrong

5th June 2014

Totally non-investment related recommendation

"Those who don't study history are doomed to repeat it. Yet those who *do* study history are doomed to stand by helplessly while everyone else repeats it."

This month's Strategy Thoughts is a little later than usual. This has nothing to do with markets or my travel, rather it is because of a book that I had to finish. Last year a reader recommended that I read the bestselling book by Jonas Jonasson 'The hundred year old man who climbed out of the window and disappeared', I did and I loved it. The same reader recently let me know that Jonasson had a new book out and that if I liked the first I would like 'The Girl who Saved the King of Sweden'. My wife gave me the book for my birthday last week and, having finished it this morning, I can say it was just as brilliant as 'the hundred year old man'.

Both books explore wonderful coincidences and recurrences that take place over multiple periods of up to several decades in length, just like the markets. But neither book has anything to do with investing, except that they are both brilliant studies in history and human behaviour, which after all is what drives markets. I recommend them both wholeheartedly.

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